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## Obligations Conference

### 1. Introduction

There are many issues associated with good faith that will ultimately confront the Australian High Court<sup>1</sup> and a number of these have been well canvassed.<sup>2</sup> However, one significant issue has attracted relatively little comment. To date, a number of Australian courts (lower in the judicial hierarchy) have been prepared to hold directly, tacitly accept or assume (without making a final determination)<sup>3</sup> that good faith is implied (as a matter of law) in the performance and enforcement of a very broad class of contract, namely commercial contracts per se. This broad approach is demonstrated in decisions from the Federal Court,<sup>4</sup> the New South Wales Court of Appeal,<sup>5</sup> the Supreme Courts of Victoria<sup>6</sup> and Western Australia<sup>7</sup> and has crept into pleadings in commercial matters in Queensland.<sup>8</sup>

The potential implications of this broad approach to good faith will be examined by the use of two case studies, both involving contractual opportunism (and a consequent consideration of motive).

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<sup>1</sup> A decision of the High Court is still awaited. In *Royal Botanic Gardens and Domain Trust v South Sydney City Council* [2002] HCA 5; (2002) 186 ALR 289 Gleeson CJ, Gaudron, McHugh, Gummow and Hayne JJ noted (at para 40) that whilst the issues respecting the existence and scope of a 'good faith' doctrine are important, it was an inappropriate occasion to consider them. Justice Kirby (at para 89) and Justice Callinan (at para 156) also did not consider it necessary to address these issues.

<sup>2</sup> JM Paterson, 'Good Faith in Commercial Contracts? A Franchising Case Study' (2001) 29(4) *ABLR* 270; E Webb, 'The Scope of the Implied Duty of Good Faith-Lessons from Commercial Retail Tenancy Cases' (2001) 9 *APLJ* 1; J W Carter and A Stewart, 'Interpretation, Good Faith and the 'True Meaning' of Contracts: The Royal Botanic Decision', (2002) 18 *JCL* 1; T M Carlin, 'The Rise (and Fall) of Implied Duties of Good Faith in Contractual Performance in Australia', (2002) 25(1) *UNSW Law Journal* 99; E Peden, *Good Faith in the Performance of Contracts*, (Butterworths, Sydney, 2003); J W Carter and Elizabeth Peden, 'Good Faith in Australian Contract Law' (2003) 19 *JCL* 1.

<sup>3</sup> The approach of the Supreme Court of Western Australia Full Court in *Central Exchange Ltd v Anaconda Nickel Ltd* [2002] WASCA 94, [13], [55] and also the New South Wales Court of Appeal in *Vodafone Pacific Ltd v Mobile Innovations Ltd* [2004] NSWCA 15, [191]..

<sup>4</sup> In *Garry Rogers Motors (Aust) Pty Ltd v Subaru (Aust) Pty Ltd* [1999] FCA 903, Finkelstein J opined that a term of good faith will be implied in perhaps all commercial contracts [34]. Also, *South Sydney District Rugby League Football Club Ltd v News Ltd* [2000] FCA 1541, [393-394].

<sup>5</sup> *Alcatel Australia Ltd v Scarcella* [1998] 44 NSWLR 349, 369; *Burger King Corp v Hungry Jack's Pty Ltd* [2001] NSWCA 187 [159]; *Vodafone Pacific Ltd v Mobile Innovations Ltd* [2004] NSWCA 15, [191].

<sup>6</sup> *Far Horizons Pty Ltd v McDonalds Australia Ltd* [2000] VSC 310, [120]; *Commonwealth Bank of Australia v Renstell Nominees Pty Ltd* [2001] VSC 167; *Varangian v OFM Capital Limited* [2003] VSC 444; *Cathedral Place Pty Ltd v Hyatt Australia Ltd* [2003] VSC 385.

<sup>7</sup> *Central Exchange Ltd v Anaconda Nickel Ltd* [2002] WASCA 94.

<sup>8</sup> *Elfic Ltd & Ors v Macks & Ors* [2000] QSC 18, [109]; *Laurelmont Pty Ltd v Stockdale & Leggo (Queensland) Pty Ltd* [2001] QCA 212; *Cook's Construction Pty Ltd v Stork ICM Australia Pty Ltd* [2004] QSC 66, [20].

## 2.1 Case study 1

Two companies enter a 60 day contract for the sale and purchase of commercial realty. The contract expressly provides that time is of the essence. After having granted a number of extensions (on each occasion the essentiality of the time provision having been affirmed) the contract is finally due for settlement some 120 days later. Unfortunately, problems associated with obtaining finance will preclude the buyer from settling on the due date but it is established that the buyer will be in a position to settle the next day<sup>9</sup>. As the buyer has paid a significant deposit and the property market has been steadily rising, the seller elects to terminate the contract and forfeit the deposit confident in the expectation that the property will be resold for a larger amount.

Conventional analysis (without good faith considerations) may proceed as follows:

## 2.2 Without Good Faith

We have a commercial contract negotiated at arms length by parties on equal footing such that it is unlikely that the contractual relationship would ordinarily be construed as giving rise to fiduciary duties.<sup>10</sup> On existing High Court authority, the only protection that may be available for the defaulting buyer under the land sale contract would be equitable relief against forfeiture or, more correctly, the possibility of specific performance being available as a remedy notwithstanding the termination of the contract for breach of the essential time provision.<sup>11</sup> However, consistent with *Tanwar Enterprises Pty Ltd v Cauchi*<sup>12</sup> and other well settled authority the buyer's prospects of success would appear remote as it is not against conscience (on these facts)<sup>13</sup> for the seller to terminate.<sup>14</sup>

Adopting conventional analysis, the seller's motive (to generate profit at the expense of the buyer) in exercising the contractual right of termination for breach of the essential time provision, is of no relevance. Would this result change if a dash of good faith is added to the contractual mix?

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<sup>9</sup> Factual circumstances similar to those prevailing in *Tanwar Enterprises v Cauchi* [2003] HCA 57; 201 ALR 359 (where a one day delay was occasioned by foreign exchange control authorities).

<sup>10</sup> *Hospital Products Ltd v United States Surgical Corporation* (1984) 156 CLR 41.

<sup>11</sup> Strict doctrinal rules dictate that relief against forfeiture concerns the forfeiture of proprietary interests: G J Tolhurst and J W Carter, 'Relief Against Forfeiture in the High Court of Australia', (2004) 20 JCL 1, 8.

<sup>12</sup> [2003] HCA 57; 201 ALR 359.

<sup>13</sup> The default was not caused by fraud, accident, mistake or surprise such as to render it unconscionable or inequitable for the seller to rely on its legal rights. The default could not be described as an unforeseen event, even though unintended and undesired.

<sup>14</sup> Cf *Legione v Hately* (1983) 152 CLR 406; *Stern v McArthur* (1988) 165 CLR 489.

## 2.3 With good faith

From slow beginnings,<sup>15</sup> an obligation of good faith in contractual performance and enforcement is emerging in Australian judicial decisions.<sup>16</sup> Unfortunately this judicial recognition of an obligation of good faith in contractual performance and enforcement has occurred in a manner that has been described as 'tortured'<sup>17</sup> both in its application of precedent and its application of relevant legal tests. Not only is judicial division apparent but statements of public policy principles have been scant. There is relatively little express discussion of the theoretical perspective that may, as a matter of policy, support the implication of a good faith obligation. For this reason, unresolved issues are legion.<sup>18</sup> For the present time, the only observation that can be made with a degree of certainty is that the obligation of good faith in contractual performance and enforcement is arising in the form of an implied contractual term<sup>19</sup> with the implication commonly being made, as a matter of law,<sup>20</sup> in commercial contracts.<sup>21</sup>

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<sup>15</sup> From the seminal judgment of Priestley JA in *Renard Constructions (ME) Pty Ltd v Minister for Public Works* (1992) 26 NSWLR 234.

<sup>16</sup> As previously noted, a decision of the High Court is still awaited.

<sup>17</sup> T M Carlin, 'The Rise (and Fall) of Implied Duties of Good Faith in Contractual Performance in Australia', (2002) 25(1) *UNSW Law Journal* 99, 122.

<sup>18</sup> A few examples will suffice: Is the good faith obligation tantamount to an obligation to act reasonably in contractual performance? (An approach of this sort would be contrary to the traditional common law approach. The traditional view at common law is that there is no requirement that contractual rights be exercised in a reasonable way: *White & Carter (Councils) Ltd v McGregor* [1962] AC 413.) Should good faith be equated to a fiduciary standard? (This possibility has raised concerns for certain commentators: JW Carter and A Stewart, 'Interpretation, Good Faith and the 'True Meaning' of Contracts: The Royal Botanic Decision', (2002) 18 *JCL* 1, 13.) Does an obligation of good faith apply to the exercise of contractual rights in the same manner as it may apply to the exercise of a contractual discretion? What correlation is there (if any) between good faith and unconscionability? (Some seek to equate the notions of unconscionability and good faith. Refer to Stapleton, 'Good Faith in Private Law', [1999] *CLP* 1 and E Webb, 'The Scope of the Implied Duty of Good Faith-Lessons from Commercial Retail Tenancy Cases' (2001) 9 *APLJ* 1.) Can there be an implied term requiring good faith contractual performance and enforcement if there is an inconsistent express contractual term? (On general principles, it would be expected that primacy would be accorded to the express term but contrast the approach of the majority in *Johnstone v Bloomsbury Health Authority* [1991] 2 WLR 1362. In the Australian context refer to *Australian Mutual Provident Society v 400 St Kilda Road Pty Ltd* [1991] 2 VR 417.) What is the effect of a 'sole discretion' clause? Is it possible to successfully exclude (by way of an express contractual provision) an obligation of good faith in contractual performance and enforcement?

<sup>19</sup> Notwithstanding that this approach has been stridently criticized by certain commentators: J W Carter and Elizabeth Peden, 'Good Faith in Australian Contract Law' (2003) 19 *JCL* 1.

<sup>20</sup> Although not uniformly, in a small number of reported Australian decisions the implication as been made, or treated, as a matter of fact, for example: *Advance Fitness v Bondi Diggers* [1999] NSWSC 264; *Dalcon Constructions Pty Ltd v State Housing Commission* (1998) 14 BCLC 477.

<sup>21</sup> In *Burger King Corporation v Hungry Jack's Pty Ltd* [2001] NSWCA 187 the New South Wales Court of Appeal (Sheller, Beazley and Stein JJA) observed [164] that there was an increasing acceptance that a term of good faith was to be implied as a matter of law, which approach was considered to be correct.

The contract (in case study 1) can clearly be characterized as a commercial contract.<sup>22</sup> If the generally prevailing lower court view was adopted by the High Court of Australia, an obligation of good faith will be implied, as a matter of law, as an incident of this contract meaning the seller would need to demonstrate (if challenged) that the contractual right of termination was exercised in good faith. If the seller's motivation in electing to terminate was purely opportunistic, this may be problematic.<sup>23</sup> In the context of a contract where a number of extensions have already been granted, a further demonstrated delay of one day only would not appear onerous<sup>24</sup> particularly given a seller's entitlement to seek interest on the balance purchase price for the period of the delay.

In the absence of unconscionable conduct by the seller, this potential fetter on the seller's rights would obviously not sit comfortably with well established principles applicable to land sale contracts.<sup>25</sup> Where time is of the essence, a buyer is taken to understand that a failure to settle on the due date will make the deposit liable to forfeiture.<sup>26</sup> Further, the possibility that relief may be available at common law (based upon an implied obligation of good faith), in circumstances where, on traditional analysis, relief would not be available in equity, may be characterized by some as a paradox.<sup>27</sup>

### 3.1 Case study 2

A local manufacturing company (the 'manufacturer') enters a 5 year distributorship contract with a second company that will act as the sole distributor (the 'distributor') of the manufacturer's products. The distributor buys the manufacturer's product and on sells the product on its own behalf. Under the terms of the contract the product is to be paid for within 7 days of supply and the contract expressly provides that time is of the essence. After two years of operation the distribution rights have proven to be very lucrative and the manufacturer would like to terminate the contract to gain these valuable rights for itself (and this can be established). Unfortunately on the day payment is due for

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<sup>22</sup> *Tanwar Enterprises v Cauchi* [2003] HCA 57; 201 ALR 359 [113] (Kirby J).

<sup>23</sup> Stack refers to a line of real estate cases, mostly from Ontario that has held that a contractual entitlement to walk away from a contract of sale cannot be exercised in an arbitrary or capricious manner. In these cases a clause such as a 'time of the essence' clause was sought to be used to escape at the last minute from a contract that, for one reason or another, became unprofitable. Stack goes on to note that where a community based 'reasonable' standard was applied the party was denied the benefit of the contractual entitlement. However, in decisions where an 'interpretive' standard (a standard based on the contractual regime and the reasonable expectations arising from it) was used, a very different conclusion was reached: David Stack, 'The Two Standards of Good Faith in Canadian Contract Law', (1999) 62 *Saskatchewan Law Review* 201, 205-210.

<sup>24</sup> Tolhurst and Carter make a similar observation: above n 11, 11.

<sup>25</sup> *Tanwar Enterprises v Cauchi* [2003] HCA 57; 201 ALR 359 being the latest decision in a line of authority.

<sup>26</sup> Consistent with the function of a deposit being an earnest to bind the bargain: *Howe v Smith* (1884) 27 Ch D 89, 101-102; *Wilson v Kingsgate Mining Industries Pty Ltd* [1973] 2 NSWLR 713, 735.

<sup>27</sup> J W Carter and Elizabeth Peden, above n 19, 16.

the most recent supply of goods it becomes apparent that problems associated with obtaining finance will preclude the distributor from making payment but it is established that the distributor will be in a position to settle the next day. The manufacturer elects to terminate the contract for breach of the condition.

### 3.2 Without good faith

Once again, in the context of a commercial contract negotiated at arms length by parties on equal footing, without an obligation of good faith our distributor is clearly in a difficult predicament and may have little recourse against what some may see as the cynical resort<sup>28</sup> to black letter rights under the contract.<sup>29</sup>

### 3.3 With good faith

If generally prevailing lower court authority is followed, this contract would, again, be characterized as a commercial contract with an attendant obligation of good faith. Again, this would mean that the manufacturer would need to demonstrate (if challenged) that the contractual right of termination was exercised in good faith which will be difficult if the facts establish that the sole motivating factor was the extraneous purpose<sup>30</sup> of usurping the distributor's rights.<sup>31</sup>

### 4.1 Contractual context

Adopting the prevailing good faith model, the results in both case studies may well be the same. Subject to demonstrating a lack of good faith,<sup>32</sup> a remedy may

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<sup>28</sup> In seeking to regain control of the distribution rights, the manufacturer's conduct may be described, like that of Burger King Corp in *Burger King Corp v Hungry Jack's Pty Ltd* [2001] NSWCA 187, as 'commercially reprehensible'. [424]

<sup>29</sup> To adopt wording (descriptive of a lack of good faith) as used by Barrett J in *Overlook v Foxtel* [2002] NSWSC 17, [83].

<sup>30</sup> To adopt (in part) the language of Mandie J in *Bamco Villa Pty Ltd v Montedeen Pty Ltd; Delta Car Rentals Aust Pty Ltd v Bamco Villa Pty Ltd* [2001] VSC 192, [162] Cf *Apple Communications v Optus Mobile* [2001] NSWSC 635.

<sup>31</sup> This would tend to suggest that the contractual right was exercised in bad faith (utilizing Professor Summers' excluder analysis: R S Summers, 'Good Faith in General Contract Law and the Sales Provisions of the Uniform Commercial Code', (1968) 54 *Va L Rev* 195)

<sup>32</sup> It is not my intention in this paper to consider the meaning and content of the good faith obligation. There is a wealth of literature concerning the meaning of the term 'good faith', particularly in the American context. Reference may be made to the following articles: MG Bridge, Does Anglo-Canadian Contract Law need a Doctrine of Good Faith?' (1984) 9 *Canadian BLJ* 385; R Brownsword, N Hird and G Howells (eds), *Good Faith in Contract: Concept and Context*, Aldershot, Dartmouth, 1999; R Brownsword, 'Two Concepts of Good Faith' (1994) 7 *JCL* 197; SJ Burton, 'Breach of Contract and the Common Law Duty to Perform in Good Faith' (1980) 94 *Harvard Law Review* 369; JW Carter and MP Furmston, 'Good Faith and Fairness in the Negotiation of Contracts' (1994) 8 *JCL* (part 1); (1994) 8 *JCL* 93 (part 2); HK Lucke, 'Good Faith and Contractual Performance' in PD Finn (ed), *Essays on Contract Law*, Law Book Co, Sydney, 1987; E Maloney, 'Contracts and the Concept of Good Faith' (1993) 23 *ACLN* 32; AF Mason, 'Contract, Good Faith and Equitable Standards in Fair Dealing' (2000) 116 *Law Quarterly Review* 66; JM Paterson, 'Good Faith in Commercial Contracts? A Franchising Case Study' (2001) 29(4) *ABLR* 270; E Peden, *Good Faith in the Performance of Contracts*, (Butterworths, Sydney, 2003);

be available for the buyer in case study 1 and the distributor in case study 2. The question is whether it is appropriate, for the motive of both the seller and the manufacturer (as the parties exercising contractual rights in case study one and two respectively) to be challenged? Should these situations be capable of being distinguished? In other words, assuming good faith is to operate in a certain class (or category) of contract,<sup>33</sup> is the class of 'commercial contract' an appropriate good faith filter or does the filter need refinement? Do the case studies suggest that commercial contracts are sufficiently homogenous such that a good faith obligation should be implied, as a matter of law, in all contracts falling within this class? To consider this dilemma it is necessary to briefly consider the operation of contractual terms implied as a matter of law.

#### 4.2 Implication as a matter of law in a certain class of contract

Adopting the generally prevailing view, terms implied as a matter of law<sup>34</sup> are contractual terms which the law implies as a necessary incident of a definable class of contractual relationship.<sup>35</sup> In these circumstances, the very nature of a contract (in the particular class) means the implied term will operate regardless of the intentions of the contractual parties.<sup>36</sup>

The first requirement is that there be a definable class of contractual relationship.<sup>37</sup> Unfortunately, outside certain recognized classes,<sup>38</sup> the cases provide little guidance concerning what other classes of contract should attract the operation of implied contractual terms.<sup>39</sup> Depending on whether the class of contract is defined generally or, more specifically, the courts may be accused of over- or under-inclusion.<sup>40</sup> The obvious consequence associated with the adoption of a broad class of contract, such as 'commercial contracts', is that in all future cases, involving a contract that may be classed as a commercial contract, the implication of a contractual term of good faith will be made automatically. As exemplified by the case studies, this would mean, amongst other things, that the

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D Stack, 'The Two Standards of Good Faith in Canadian Contract Law' (1999) 62 *Saskatchewan Law Review* 201; RS Summers, 'Good faith in General Contract Law and the Sales Provisions of the Uniform Commercial Code' (1968) 54 *Virginia L Rev* 195; RS Summers, 'The General Duty of Good Faith-its Recognition and Conceptualisation' (1982) *Cornell Law Review* 810; SM Waddams, 'Good Faith, Unconscionability and Reasonable Expectations' (1995) 9 *JCL* 55; D Yates, 'Two Concepts of Good Faith' (1995) 8 *JCL* 145.

<sup>33</sup> The assumption being made at lower court level.

<sup>34</sup> Sometimes described as default rules.

<sup>35</sup> *Australis Media Holdings Pty Ltd v Telstra Corporation Ltd* (1998) 43 NSWLR 104, 122-123.

<sup>36</sup> Being based on imputed intention: *Breen v Williams* (1996) 186 CLR 71, 103.

<sup>37</sup> The classes of contracts in which the law will imply terms is not closed: *Castlemaine Tooheys Ltd v Carlton & United Breweries Ltd* (1987) 10 NSWLR 468, 487 (Hope JA).

<sup>38</sup> Landlord and tenant, employer and employee and contracts of bailment.

<sup>39</sup> The criteria by which contracts are to be classified for the purpose of implying terms by law have received only passing attention by judges or commentators: M Bryan and M P Ellinghaus, 'Fault Lines in the Law of Obligations: *Roxborough v Rothmans of Pall Mall Australia Ltd*' (2000) 22 (4) *Syd LR* 636, 650.

<sup>40</sup> A Phang, 'Implied Terms in English Law-Some Recent Developments' [1993] *JBL* 242, 247.

motive of a party terminating a commercial contract could be universally challenged.<sup>41</sup>

The second requirement<sup>42</sup> is to satisfy the test of necessity.<sup>43</sup> In this context,<sup>44</sup> 'necessity' means 'unless such a term be implied, the enjoyment of the rights conferred by the contract would or could be rendered nugatory, worthless, or, perhaps, be seriously undermined.'<sup>45</sup> Once again, significant judicial discussion of this requirement of necessity (and the policy reasons<sup>46</sup> that may support the implication of a contractual term as a matter of law) being satisfied across the whole range of commercial contracts, is not apparent. Perhaps the absence of any significant discussion of both these requirements is an indication that the good faith filter may need refinement. Aspects of relational contract theory may suggest the means by which the filter could be refined.

## 5. Good faith-a relational notion?<sup>47</sup>

Perhaps the most recognized contribution of Ian Macneil's work in contract law<sup>48</sup> was his assertion that legally enforceable contracts exist on a continuum (or spectrum) ranging from highly discrete relations at one end of the continuum to highly relational (or highly intertwined) relations at the other end.<sup>49</sup> The continuum is a reflection of the importance of the relations between the contractual parties. Macneil provides a hypothetical example of a highly discrete transaction:<sup>50</sup> the cash purchase of gasoline at a station on the New Jersey turnpike by someone rarely traveling the road.<sup>51</sup>

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<sup>41</sup> Waddams is of the view that an overriding duty of good faith is not sufficiently objective because it leads to consideration of the subjective motives of the parties: S M Waddams, 'Good Faith, Unconscionability and Reasonable Expectations' (1995) 9 *JCL* 55, 63-64.

<sup>42</sup> Phang refers to this two stage test for a term implied by law: A Phang, above n 40, 245-246.

<sup>43</sup> *Esso Australia Resources Ltd v Plowman* (1995) 183 CLR 10, 30 (Mason CJ).

<sup>44</sup> By contrast to the test of necessity in the context of terms implied in fact the criterion of necessity for terms implied in law is much broader as it involves policy factors.

<sup>45</sup> *Byrne v Australian Airlines Ltd* (1995) 185 CLR 410, 450.

<sup>46</sup> Policy reasons have been expressly articulated in the past, see, for example, *Lister v Romford Ice* [1957] AC 555, 576-579; *Simonius Vischer & Co Holt & Thompson* [1979] 2 NSWLR 322, 348. In the specific context of an implied obligation of good faith, Finn J has expressly acknowledged that considerations of public policy can and do have an overt role to play: *Hughes Aircraft Systems International v Airservices Australia* (1997) 117 ALR 1, 39.

<sup>47</sup> Macneil suggested in 1978 that good faith was a relational notion: I R Macneil, 'Contracts: Adjustment of Long-Term Economic Relations Under Classical, Neoclassical and Relational Contract Law', (1978) 72 *Northwestern University Law Review* 854, 890.

<sup>48</sup> As acknowledged by Macneil himself: I R Macneil, 'Relational Contract Theory: Challenges and Queries' (2000) 94 *Northwestern University Law Review* 877, 894.

<sup>49</sup> This spectrum of contractual behaviour is sometimes treated as relational contract theory in itself, although even as a theory it is only an adjunct to essential contract theory: I R Macneil *id.*

<sup>50</sup> Macneil acknowledged that that like the ends of rainbows, the ends of the spectrum are mythical. For this reason, a wholly discrete transaction can only be a theoretical example: I R Macneil above n 48, 896.

<sup>51</sup> I R Macneil, above n 47, 857.



The classical model of contract law<sup>52</sup> could well be based on this type of discrete (or spot)<sup>53</sup> transaction,<sup>54</sup> premised upon an adversarial ethic where contractual parties legitimately seek to maximise their own interests.<sup>55</sup> As a corollary of the underlying ideology of liberal individualism<sup>56</sup> (or in a market context 'market individualism')<sup>57</sup>, contractual performance and the exercise of contractual rights and discretions is virtually unrestrained by considerations of the reasonable expectations or the legitimate interests of the contractual counter-party.<sup>58</sup> It is these reasonable expectations<sup>59</sup> or legitimate interests<sup>60</sup> that an obligation of good faith in contractual performance and enforcement may operate to protect.

<sup>52</sup> A model consistent with, and reflective of, the economic theory of laissez-faire: AF Mason, 'Contract, Good Faith and Equitable Standards in Fair Dealing' (2000) 116 *Law Quarterly Review* 66, 70

<sup>53</sup> "Classical contract law is based on certain implicit paradigm cases, the most common of which is the contract for an identified commodity between two strangers operating in a perfect spot market": *Bobux Marketing Ltd v Raynor Marketing Ltd* [2001] NZCA 348 [33] (Thomas J).

<sup>54</sup> Many would argue that the fundamental flaw of the classical conception of contractual law was that it was based on a false premise namely that most contracts are discrete rather than discrete contracts being unusual: Refer for example to Melvin A Eisenberg, 'Relational Contracts' in *Good Faith in Contract Law* (Eds Beatson and Friedmann, 1995), 297.

<sup>55</sup> Acting in the manner of what Gauthier describes as a straightforward maximiser, that is a person who attends only to their own interests: D Gauthier, *Morals by Agreement*, Oxford, Clarendon Press, 1986 as referred to by R Brownsword, 'Positive, Negative, Neutral: the Reception of Good Faith in English Contract Law' in R Brownsword, N Hird and G Howells (eds), *Good Faith in Contract: Concept and Context*, Aldershot, Dartmouth, 1999, 13, 32

<sup>56</sup> Bigwood refers to contract law's embracement of individualism as its dominant informing ideology: R Bigwood, 'Conscience and the Liberal Conception of Contract: Observing Basic Distinctions Part II' (2000) 16 *JCL* 191, 203

<sup>57</sup> A model of self-interested dealers converging on a market-place, making their one-off exchanges, and going their separate ways: IR Macneil, 'The Many Futures of Contract' (1974) 47 *Southern California Law Review* 691

<sup>58</sup> Subject only to an observance of the like freedom and equal opportunity of all others to pursue their own self-interest: R Bigwood, 'Conscience and the Liberal Conception of Contract: Observing Basic Distinctions Part 1' (2000) 16 *JCL* 1, 20

<sup>59</sup> Sir Anthony Mason has noted that the movement in the general law may be associated with a new focus on the reasonable expectations of the parties: AF Mason, above n 52, 72. In the English context, Justice Steyne has observed, extrajudicially, that a thread runs through contract law that effect must be given to the reasonable expectations of honest men: J Steyne, 'Contract Law: Fulfilling the Reasonable Expectations of Honest Men' (1997) *LQR* 433 (this observation is consistent with Justice Steyn's judicial approach in *First Energy (U.K) Ltd v Hungarian International Bank Ltd* [1993] 2 Lloyd's Rep 194). Similarly in the United States, the Official Comment to s205 of the Restatement (2d) of Contracts links good faith with the justified expectations of the contractual counter-party.

<sup>60</sup> Finn equates a duty to act in good faith with a positive requirement to have regard to the other contractual party's legitimate interests: PD Finn, 'The Fiduciary Principle' in *Equity, Fiduciaries and Trusts*, TG Youdan (ed), Carswell, Toronto, 1989, 4 as referred to by JW Carter and MP Furmston, 'Good Faith and Fairness in the Negotiation of Contracts Part 1' (1994-1995) 8 *JCL* 1, 6. Lubbe also suggests that good faith requires that a measure of recognition and respect be afforded to the legitimate interests of the other party: Gerhard Lubbe, 'Bona Fides, Billikheid en die Openbare Belang in die Suid-Afrikaanse Kontrakereg' (1990) 1 *Stellenbosch LR* 7 as referred to by Dale Hutchison, 'Good Faith in the South African Law of Contract' in R Brownsword, N Hird and G Howells (eds), *Good Faith in Contract: Concept and Context*, Aldershot, Dartmouth, 1999, 213, 232; Refer also to WP Yee, 'Protecting Parties' Reasonable Expectation: A General Principle of Good Faith': (2001) 1(2) *Oxford University Commonwealth Law Journal* 195; Although

By contrast, relational contracts are often contracts governing business relationships that exist and evolve over long periods of time.<sup>61</sup> Commercial contracts that are typically regarded as being relational are distributorships, agency relationships, partnerships, joint ventures, long-term leases and franchise agreements.<sup>62</sup> Relational contracts of this type are obviously increasingly common and economically important.<sup>63</sup> A common feature of these contracts (unlike spot or discrete contracts) is that it is difficult to optimally allocate all risks at the time of contracting due to the possibility of unforeseen contingencies and also the common desire of one contractual party to retain a high degree of control. The success, or otherwise, of the relationship may well be dependent on a level of future co-operation in both performance and planning. The formation of a relational contract is marked by expectations of loyalty and interdependence which then becomes the basis for the parties rational economic planning.<sup>64</sup> As both parties reasonably expect<sup>65</sup> that mutual cooperation will promote their economic interests,<sup>66</sup> a party to this type of contract does not (rationally) intend to assume the risk of opportunistic behaviour,<sup>67</sup> as may be the case in the traditional adversarial context.<sup>68</sup>

Macneil's continuum is consistent with empirical studies carried out by social scientists that have repeatedly confirmed that relational norms of honesty, trust

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not in the context of a good faith claim, a similar judicial approach was taken by Mason J in *Hospital Products Ltd v United States Surgical Corp* (1984) 156 CLR 41 where he recognised an obligation upon a defendant to have due regard to the plaintiff's interests. Such an approach has also been followed in other common law jurisdictions: in the Supreme Court of Nova Scotia, Kelly J opined that the good faith obligation would be breached if a party, without reasonable justification, acted in a manner to defeat the legitimate expectations of the other party: *Gateway Realty Ltd v Arton Holdings Ltd (No.3)* (1991) 106 NSR (2d) 180

<sup>61</sup> Although relational contracts need not be long-term contracts: *Bobux Marketing Ltd v Raynor Marketing Ltd* [2001] NZCA 348 [43] (Thomas J).

<sup>62</sup> *Bobux Marketing Ltd v Raynor Marketing Ltd* [2001] NZCA 348, [42].

<sup>63</sup> In Australia the franchise sector alone has an annual turnover of more than \$80 billion, and employs over 600,000 people. This sector also generates over \$290 million in annual export income for Australia (figures quoted by Cheryl Scott, Austrade's franchise and service export industry specialist: <http://www.findlaw.com.au/news/default.asp?task=read&id=19243&site=LE>)

<sup>64</sup> *Bobux Marketing Ltd v Raynor Marketing Ltd* [2001] NZCA 348 [43] (Thomas J) (citing a number of commentators for this proposition).

<sup>65</sup> The type of reasonable expectation expressly recognised by Wilson J in *Hospital Products Ltd v United States Surgical Corporation* (1984) 156 CLR 41, 117 when noting that every sole distributorship contract would induce in both parties a reasonable expectation of mutual benefit accruing from the 'best efforts' of the distributor.

<sup>66</sup> The parties having a mutual interest in the successful performance of their agreement: *Bobux Marketing Ltd v Raynor Marketing Ltd* [2001] NZCA 348 [42] (Thomas J).

<sup>67</sup> Hadfield has suggested an interpretation of 'good faith' as fidelity to an implicit obligation not to use discretion opportunistically: 'The Second Wave of Law and Economic: Learning to Surf' in M Richardson and G Hadfield, *The Second Wave of Law and Economics* (Federation Press, 1999), 60 as referred to by J M Paterson, 'Good Faith in Commercial Contracts? A Franchising Case Study' (2001) 29 ABLR 270, 290.

<sup>68</sup> With a relational contract there may also be a significant expectation of altruistic behaviour: I R Macneil, above n 47, 905.

and flexibility form the foundation of a successful long-term commercial contractual relationship.<sup>69</sup> From the pioneering work of Professor Stewart Macaulay in the United States in the 1960's,<sup>70</sup> Beale and Dugdale in the United Kingdom in the 1970's<sup>71</sup> and more recently the work of Arrighetti, Bachmann and Deakin in the United Kingdom and Europe in the mid-1990's<sup>72</sup> it has been demonstrated that commercial dealings of this nature are characterized by these self-imposed norms of behaviour underpinned by a rationale of self-interest and profit-maximisation.<sup>73</sup>

Also consistent with Macneil's continuum, these empirical studies are consistent with relational dealings being only one paradigm-not all commercial contracting is relational.<sup>74</sup> In other words, relational concepts like trust and fair dealing are not of general application and do not necessarily carry through to all business transactions.<sup>75</sup> The relational world of business contracting must be distinguished from the non-relational (discrete) world of business contracting.<sup>76</sup> In a survey of 182 corporations of various sizes in all parts of the United States, Weintraub<sup>77</sup> also confirmed this distinction between relational and discrete commercial contracts.<sup>78</sup>

## 5.2. A narrower gauge?

When the vexed issue of good faith finally falls for determination by the High Court, the challenge will be to develop a model that will provide a platform for coherent future development. Ideally, the model should be capable of securing a number of economic and pragmatic objectives. The model should provide contractual parties with greater security and more flexibility in the manner in which they are prepared to do business.<sup>79</sup> The model should reduce transaction costs by reducing self-protective 'defensive expenditures'<sup>80</sup> and 'exhaustive

<sup>69</sup> Dr Vivien Goldwasser and Tony Ciro, 'Standards of Behaviour in Commercial Contracting' (2002) 30 *ABLR* 369, 369.

<sup>70</sup> S Macaulay, 'Non-Contractual Relations in Business: A Preliminary Study' (1963) 28 *Am Soc Rev* 55.

<sup>71</sup> H Beale and T Dugdale, 'Contracts Between Businessmen: Planning and the Use of Contractual Remedies' (1975) 2 *British Journal of Law and Society* 45.

<sup>72</sup> A Arrighetti, R Bachmann and S Deakin, 'Contract Law, Social Norms and Inter-firm Cooperation' (1997) 21 *Cambridge J Economics* 171.

<sup>73</sup> Also demonstrating a clear gap between classical contract theory and the operational world of contractual relations: Dr Vivien Goldwasser and Tony Ciro, above n 69, 369.

<sup>74</sup> Dr Vivien Goldwasser and Tony Ciro, above n 69, 370.

<sup>75</sup> *Ibid*, 371.

<sup>76</sup> *Ibid*, 393.

<sup>77</sup> R J Weintraub, 'A Survey of Contract Practice and Policy' [1992] *Wis L Rev* 1, 19.

<sup>78</sup> As referred to by Dr Vivien Goldwasser and Tony Ciro, above n 69, 373.

<sup>79</sup> R Brownsword, 'Positive, Negative, Neutral: the Reception of Good Faith in English Contract Law' in R Brownsword, N Hird and G Howells (eds), *Good Faith in Contract: Concept and Context*, Aldershot, Dartmouth, 1999, 13, 31.

<sup>80</sup> T Wilhelmsson, 'Good Faith and the Duty of Disclosure in Commercial Contracting-The Nordic Experience' in R Brownsword, N Hird and G Howells (eds), *Good Faith in Contract: Concept and Context*, Aldershot, Dartmouth, 1999, 165, 178.

contract planning'<sup>81</sup> and thereby enhance economic efficiency. The model should deter contractual opportunism (where inappropriate),<sup>82</sup> allow the optimisation of the parties' mutual interests and encourage contracting.<sup>83</sup> In considering these requirements, a key issue will be: when is a cooperative (rather than an adversarial) model appropriate and in what category of contract?

Is there is a model capable of achieving these objectives? One possibility<sup>84</sup> may be for an obligation of good faith in contractual performance and enforcement to be implied, as a matter of law, in a narrower class, being commercial contracts that are relational in nature. This suggested model recognizes that the traditional adversarial contractual model is inappropriate for relational commercial contracts but still leaves scope for the operation of the traditional adversarial model<sup>85</sup> for commercial contracts that are not relational in nature. Despite suggestions to the contrary,<sup>86</sup> it is submitted that it is unnecessary to imply an obligation of good faith, as a matter of law, in all commercial contracts. The adoption of such an approach fails to heed the economically diverse nature of the commercial contracting environment.<sup>87</sup>

By contrast, the suggested model has the flexibility to accommodate multifarious commercial activity. Adopting this approach, the commercial contractual context will be relevant, rather than viewing commercial contracts as an undifferentiated

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<sup>81</sup> AJH Loke, 'Fiduciary Duties and Implied Duties of Good Faith' [1999] *JBL* 538, 557.

<sup>82</sup> R Posner, *Economic Analysis of Law*, 5<sup>th</sup> ed, Aspen Law & Business, 1998, 103. In this context, the observation that implied contractual terms are in reality low cost methods of deterring costly opportunistic behaviour may be well made: AM Johnson, Jnr. 'Correctly Interpreting Long-Term Leases Pursuant to Modern Contract Law: Towards a Theory of Relational Leases' (1988) 74 *Va L Rev* 751 (Footnote 135).

<sup>83</sup> Professor Smillie suggests a functional touchstone for the purpose of the law of contract is the positive encouragement of contracting. In his view, this is why the classical common law rules placed such a high value on certainty and predictability: J Smillie, 'Is Security of Contract Worth Pursuing? Reflections on the Function of Contract Law' (2000) 16 *JCL* 148, 154.

<sup>84</sup> Clearly there a number of possibilities. Peden advocates the use of good faith as a constructional tool rather than reliance being placed on implied terms (E Peden, *Good Faith in the Performance of Contracts* (LexisNexis Butterworths 2003)). However, this approach did not seem to find favour with the New South Wales Court of Appeal in *Vodafone Pacific Ltd v Mobile Innovations Ltd* [2004] NSWCA 15, [206] and may be considered (rightly or wrongly) to be inconsistent with mainstream Australian authority. A further alternative would be for the obligation of good faith in contractual performance and enforcement to be made universally as a matter of law: The approach of NC Seddon and MP Ellinghaus, *Cheshire & Fifoot's Law of Contract*, 8<sup>th</sup> Aust ed, Butterworths, Sydney, 2002, paras 10.41ff.

<sup>85</sup> Where contractual parties can legitimately seek to maximize their own interests, without any restraint on self-interested dealings.

<sup>86</sup> *Overlook v Foxtel* [2002] NSWSC 17; (2002) Aust Contracts Rep 90-143 and other decisions previously referred to in footnotes 4 to 8 inclusive.

<sup>87</sup> In certain commercial transactions (for example, the commodities world of forward trading) the concept of a co-operative search for a jointly maximized profit is an anathema to the participant's involvement in a 'zero sum game': M Bridge, 'Good Faith in Commercial Contracts', in R Brownsword, N Hird and G Howells (eds), *Good Faith in Contract: Concept and Context*, Aldershot, Dartmouth, 1999, 152.

lump to be accorded the same contractual treatment regardless of context.<sup>88</sup> For commercial contracts that are not relational in nature, the suggested model would enable the parties to continue to pursue their own interests in the unfettered manner that has historically been seen to be economically advantageous.<sup>89</sup>

### 5.3 Application

Adopting the suggested model, the contractual context in case studies one and two may be clearly distinguished. A commercial land sale contract, as in case study 1, is not relational in nature. There is no cooperative or mutual endeavour to promote economic interests. Rather, each party actively pursues their own interests with the purchaser alone bearing the risk of default in timely payment. In this commercial context an obligation of good faith in the enforcement of the contract appears unduly restrictive.

Unlike a land sale contract, a sole distributorship contract, as in case study 2, is a commercial contract that would undoubtedly be characterized as relational<sup>90</sup> in nature.<sup>91</sup> Consistent with aspects of relational contract theory (and the available empirical evidence), a party to this type of contract does not (rationally) intend to assume the risk of opportunistic behaviour of the type clearly exhibited by the manufacturer in situation two. As a potential fetter on the exercise of the manufacturer's contractual right of termination (due to the court's ability to consider contractual motive), the implied obligation of good faith seems apposite in this more restricted commercial context.

### 5.4 Support for the narrower gauge

As the available empirical evidence supports a distinction between relational and discrete commercial contracts, this may suggest the need to make the same distinction when selecting a class of commercial contract that will attract an

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<sup>88</sup> Bridge refers to the heterogeneity of commercial activity and the corresponding need to avoid treating commercial law as an undifferentiated lump to be accorded the same prescriptive treatment: M Bridge, *ibid*, 145.

<sup>89</sup> The English approach to good faith has been underpinned by an acute awareness of the need for commercial certainty particularly in international financial markets, so important to the economy of the United Kingdom: M Bridge, *above* n 87, 144. This approach may be viewed as being consistent with the importance that United Kingdom judges and lawyers attach to London's position as a centre of international commerce and finance: AF Mason, 'Contract, Good Faith and Equitable Standards in Fair Dealing' (2000) 116 *Law Quarterly Review*, 66, 83. Sir Anthony Mason has also noted (elsewhere) that certainty of contract has not been as all-consuming in Australia due to being 'neither an industrial power nor a maritime nation': Sir Anthony Mason, 'Changing the Law in a Changing Society' (1993) 67 *ALJ* 568, 573.

<sup>90</sup> In *Bobux Marketing Ltd v Raynor Marketing Ltd* [2001] NZCA 348, Thomas J held no doubt that a distributorship agreement for babies' leather booties fell within the category of relational contracts [43].

<sup>91</sup> The termination of such a long-term contract tends, to use the words of Ian Macneil, to be messily relational rather than cleanly transactional: I R Macneil, *above* n 47, 900.

implied obligation of good faith.<sup>92</sup> Some explicit judicial recognition of the non-homogenous nature of the commercial contracting environment is apparent in this context. The Dymocks New Zealand franchise litigation (that made its way to the Privy Council in 2002) is a case in point. At first instance, in the New Zealand High Court, Hammond J observed that a franchisor-franchisee relationship is more than a simple bilateral contract. It is a relational contract in which a working, ongoing relationship is set up for the mutual benefit of both parties.<sup>93</sup> Hammond J went on to observe:

“And from an economic point of view, what is central is the joint maximization of economic benefits. Both parties are to work in good faith to that end.”<sup>94</sup>

Adopting this expressly relational approach,<sup>95</sup> Hammond J found that an obligation of good faith (and confidentiality) was implied in franchise agreements as part of New South Wales law.<sup>96</sup> On appeal, the New Zealand Court of Appeal rejected the trial judge’s finding of an implied term.<sup>97</sup>

When the matter reached the Privy Council,<sup>98</sup> their lordships allowed the appeal on the basis that both the trial judge and the Court of Appeal were in error in determining that the franchisee had not repudiated their obligations under the franchise agreement. Due to this finding it was unnecessary for the Privy Council to express a concluded view on the issue of good faith. However, the very crux of the conclusion of repudiatory conduct was the recognition that franchise agreements are not ‘ordinary commercial contracts but contracts giving rise to long term mutual obligations in pursuance of what amounted in substance to a joint venture and therefore dependent upon coordinated action and cooperation.’<sup>99</sup> This comment is clearly consistent with the non-homogenous nature of commercial contracts and the clear need to have regard to the commercial context.<sup>100</sup>

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<sup>92</sup> If contract law is to be better aligned with empirically demonstrated commercial reality.

<sup>93</sup> *Dymocks Franchise Systems (NSW) Pty Ltd v Bilgola Enterprises Ltd* (1999) 8 TCLR 612, [236].

<sup>94</sup> *Id*

<sup>95</sup> An approach that also found favour with one judge (Thomas J) of the New Zealand Court of Appeal in *Bobux Marketing Ltd v Raynor Marketing Ltd* [2001] NZCA 348 [33] although the remaining two judges (Keith and Blanchard JJ) expressly declined to comment on the issue of good faith performance [81].

<sup>96</sup> The franchise agreements in question provided that the governing law was that of New South Wales.

<sup>97</sup> [2000] 3 NZLR 169 (Richardson P, Henry and Keith JJ). It should be noted that this conclusion, that an obligation of good faith was not implied in a franchise agreement as part of New South Wales law, was reached before the decision of the New South Wales Court of Appeal in *Burger King Corp v Hungry Jack’s Pty Ltd* [2001] NSWCA 187.

<sup>98</sup> *Dymocks Franchise Systems (NSW) Pty Ltd v Bilgola Enterprises Ltd* [2002] UKPC 50.

<sup>99</sup> *Dymocks Franchise Systems (NSW) Pty Ltd v Bilgola Enterprises Ltd* [2002] UKPC 50, [63].

<sup>100</sup> Similarly, in *Hospital Products Ltd v United States Surgical Corporation* (1984) 156 CLR 41, 117 the recognition (by Wilson J) that every sole distributorship contract would induce in both parties a reasonable expectation of mutual benefit accruing from the ‘best efforts’ of the distributor.

In a similar vein, although refraining from expressing a concluded view on whether duty of good faith and fair dealing should be implied,<sup>101</sup> is the approach of Finn J in *GEC Marconi Systems Pty Ltd v BHP Information Technology Pty Ltd*.<sup>102</sup>

“I consider this to be a case in which cogent grounds exist for making the implication sought. I would simply note that the Sub-Contract was a long term relational one in which cooperation and trust were to be expected because of the back-to-back nature of the ADCNET contracts.”<sup>103</sup>

Real impetus for serious reconsideration of the appropriate class, has been provided by the recent decision of the New South Wales Court of Appeal<sup>104</sup> in *Vodafone Pacific Ltd v Mobile Innovation Ltd*.<sup>105</sup> Mobile had been appointed by Vodafone as a sole or exclusive direct marketing agent under a long term Agent Service Provider (‘ASP’) contract. Amongst other things, the questions arose whether Vodafone was under an implied obligation to act in good faith in exercising its powers under the ASP contract, specifically the power of determining target levels for the acquisition of subscribers. Although the Court of Appeal was ultimately content to assume, expressly without deciding, that there was such an implied obligation,<sup>106</sup> some extremely pertinent observations were made concerning the class of contracts carrying the implied term as a legal incident.

In discussing the earlier decision of the New South Wales Court of Appeal in *Burger King Corp v Hungry Jack’s Pty Ltd*,<sup>107</sup> Giles J<sup>108</sup> observed that this decision fell short of, indeed rejected, treating commercial contracts as a class of contracts carrying the implied term as a legal incident.<sup>109</sup> Giles J then observed:

“I do not think the law has yet gone so far as to say that commercial contracts are a class of contracts carrying the implied terms as a legal incident, *and the width and indeterminacy of the class of contracts would make it a large step.*”<sup>110</sup> (Emphasis added)

## 6. Conclusion

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<sup>101</sup> Given an earlier finding on repudiation.

<sup>102</sup> [2003] FCA 50.

<sup>103</sup> *GEC Marconi Systems Pty Ltd v BHP Information Technology Pty Ltd* [2003] FCA 50, [921].

<sup>104</sup> Giles, Sheller and Ipp JJA.

<sup>105</sup> [2004] NSWCA 15.

<sup>106</sup> Unless excluded by express provision or because inconsistent with the terms of the contract: *Vodafone Pacific Ltd v Mobile Innovations Ltd* [2004] NSWCA 15, [191].

<sup>107</sup> [2001] NSWCA 187.

<sup>108</sup> Sheller and Ipp JJA concurring with the judgment delivered by Giles JA

<sup>109</sup> *Vodafone Pacific Ltd v Mobile Innovations Ltd* [2004] NSWCA 15, [189].

<sup>110</sup> *Ibid*, [191].

The decision in *Vodafone Pacific Ltd v Mobile Innovation Ltd*<sup>111</sup> is significant for two reasons. First, the New South Wales Court of Appeal<sup>112</sup> is clearly seeking to distance itself from any suggestion that *Burger King Corp v Hungry Jack's Pty Ltd*<sup>113</sup> should be viewed as authority for the proposition that an implied obligation of good faith is a legal incident of all commercial contracts. Secondly, the decision heralds the need for a careful consideration of contractual context when determining a class of contract that should attract the implied obligation.<sup>114</sup>

Given this apparent change of position by the New South Wales Court of Appeal, the platform has been laid for the adoption of a new class of contract, being a class that demonstrably satisfies the requirements for a contractual term to be implied, as a matter of law. The case studies in this paper exemplify that the adoption of a narrower class, commercial contracts that are relational in nature rather than commercial contracts per se, would screen unmeritorious good faith claims<sup>115</sup> and satisfy the test of necessity, that is, an objective of preventing contractual rights being rendered nugatory, worthless or seriously undermined. The available empirical evidence reinforces a distinction between discrete and relational commercial contracts. It is only in relational commercial transactions that there is evidence of contractual parties having a reasonable expectation that certain business norms will prevail. If good faith is concerned with protecting the reasonable expectations of contractual parties, this difference in the commercial contractual context should be reflected by the adoption of the suggested narrower class. This, in turn, may serve to appease residuary concerns about the impact of an implied obligation of good faith on economic freedom.<sup>116</sup> In short, the express recognition of good faith as a relational concept offers a structured path forward for claims arising in a commercial contractual context.

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<sup>111</sup> [2004] NSWCA 15.

<sup>112</sup> A court which has championed the good faith cause.

<sup>113</sup> [2001] NSWCA 187.

<sup>114</sup> To ensure the class selected is not too broad in its width or indeterminant.

<sup>115</sup> Courtesy of its narrower width.

<sup>116</sup> In *Royal Botanic Gardens and Domain Trust v South Sydney City Council* [2002] HCA 5; (2002) 186 ALR 289 Kirby J observed [89] that the suggested implied term of good faith appeared to be in conflict with fundamental notions of caveat emptor that are inherent (statute and equitable intervention apart) in common law conceptions of economic freedom.